Amando M Tetangco, Jr: Prospects and challenges in 2010 – the bond market in the context of the Philippine economy?

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Bloomberg Conference "Gearing for 2010. Ensuring Profitability. Containing Risk", Makati, 4 November 2009.

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A few days ago, I had the occasion to speak before an international body of Asian bankers. There, I shared my views about the future of the regional banking market and specifically raised product and policy issues that confront Asia today. These are the concerns that arise if we are to move forward as a banking hub underpinned by the region's vast economic potential.

I join you this afternoon to focus in particular on the Philippine situation. Instead of providing you with the usual parameters that come with a macro prognosis, allow me instead to discuss the bond market in the context of our broad macro-financial situation. This would be our natural recourse given the inherent relationship between interest rates and fixed-income valuation on one hand and between economic activity and capital-raising on the other.

When structure translates into operations

To talk about the Philippine bond market necessarily means talking about the Philippine government securities (GS) market. In addition, it is probably not much of an exaggeration to argue that the local bond market is inherently linked to fiscal policy. Over the last 5 decades, the national government has found itself in a budget deficit position, with the exception of 5 fiscal years. The NG funds the deficit principally by the issuance of domestic GS. Of course, as the country's macroeconomic fundamentals improved, the NG has also been able to tap the international capital market for portion of the budgetary requirement.

Nevertheless, domestic funding remains the primary funding source to a ratio of more than two-thirds of total borrowing mix. Relative to the size of the economy, outstanding GS accounted for about one-third of nominal GDP as of end 2008.

This basic structure translates into a challenging operating framework. To be sure, the national government has every interest to bring down its cost of borrowing. Yet in the same token, it is also the most active borrower in the market.

One added feature that can readily be seen from the data of the BTr is that GS issues thru ADAPS have been predominantly in the form of Treasury Bills, accounting for 58% on average since 2000. This significant amount of short-term debt invariably puts pressure on managing liquidity and fiscal authorities have to fund frequently maturing obligations.

The shorter-term debt profile also helps explain lower trading activity. As of June 2009, calculations by the ADB show a turnover ratio of 0.37 which literally means a recorded trade value of only 37 centavos per peso of outstanding government security.

At the other end of the tenor profile, many institutional participants choose to immunize their long-term obligations with long-term assets. Even those who may not have such long-dated obligations often prefer to hold Treasury Bonds to term because of the steady stream of coupons over the long-term. The net effect of both of these is that our long-term treasury issues tend to be rather illiquid. One can readily check that the long-end of the PDST-R2 series is often the "best bid" of benchmark bonds rather than actual done deals.

The irony then is that sheer volume has really not nurtured a liquid GS market. Asset price liquidity can be problematic to establish for certain issues. For some tenor buckets and specific issues, funding liquidity may also be a concern from time to time. The point has been raised that the market dominance of GS may in fact be absorbing funding liquidity away from other market instruments, curtailing the development of the latter product lines.

Market development and policy

Moving forward then, the clear mantra is to jump-start and nurture liquidity in GS. The recent launch of the trading platforms for repos and Securities Lending Transactions (SLT) separately should go a long way in institutionalizing organized secondary markets. The case of the inter-professional repo platform, for example, gives us high hopes of what lies ahead. From an outstanding amount of Php5.4 Billion as of year-end 2008, it is now at Php36.3 billion as of October this year.

What we would like to encourage is for trading activity and turnover to increase without mandating holders of long-term issues to liquidate their positions. This is of course possible only if the various tenors maintain sufficient depth while generating credible and transparent market prices. In this way, we provide investors with the level of comfort that they can exit their positions in an orderly manner without having to absorb significant distortions in valuation.

This basic approach provides an essential ingredient, that of credible prices where trades can and do occur. The BSP had previously issued in 2006 guidelines on what we deem to be acceptable benchmark prices. What we would like to see is more depth and more activity across the benchmark tenors precisely to assure investors that market prices reflect consummation of demand and supply pressures. This is the only yield curve that would eventually matter.

We understand that international accounting standards rely on “bid” rates to establish fixed income benchmark rates. In a liquid market, there would be no debate that buy-side rates would be sufficient since this would generally reflect the short-side that defines equilibrium. However, if we are starting from a fragmented market where both funding and asset price liquidity are not uniformly established, it is less clear that “done” rates are of less reference value than “bid” rates.

The yield curve is essential for policy because it allows us to eventually price corporate issues. Since GS would still enjoy the least of credit risk, the prices that come out of this market reflect the market’s premium for time. In other words, it is the pure premium for waiting. With that on hand, corporate issues can be priced then for their tenor and credit quality. The transparency of this dichotomy makes the market more efficient for investors who can now choose the combination they are prepared to absorb as an investment risk.

To this end, the BSP is quite pleased to see the debt issues being listed at the fixed income exchange. These are not only straight bonds but more recently includes two bank issues of unsecured subordinated debt. As I have remarked at a previous occasion, the listing of these corporate issues reflect the willingness of the issuer to be eventually judged by the market on the market’s terms. The fact that the last two listings are bank issues gives the BSP added pleasure because this is aligned with our stated objective of broadening the ownership base of banks while enhancing the capital market with newer instruments.

The bond market and the needs of the Philippine economy

Of course, a deep and liquid bond market that generates credible pricing has always been the plan. The real question then is what else needs to be done to put the bond market within the specific context of the Philippine economy.

I already mentioned the valuable contribution that the repo and SLT platforms can provide. These are a good start because these platforms can unlock trapped liquidity in the long-term issues for which we expect to improve on both liquidity and market turnover.

Beyond trading venues however, four initiatives come to mind.

First, it may be useful to revisit the issue of having 11 benchmark tenor buckets. It should be evident by now that having so many benchmark tenors does not necessarily improve the ability of the market to price off-the-run issues. Stated differently, the major economies typically have 4-6 benchmark tenor buckets only and this has not weighed against liquidity and the pricing of off-the-run issues. Recent initiatives to exchange short-for-long-term issues help to consolidate depth but a significant potential remains untapped.

Second, the bond market can be a more active vehicle for raising long-term capital. The fact that the GS market is as big as a third of GDP is itself not a binding constraint. Economies such as Hong Kong, Korea, Malaysia and Singapore all have significant corporate bond markets that complement their respective GS market. This would be a healthy next step for the Philippines as it broadens the financing options for corporations while reducing the gapping pressure on bank credits.

Third, we need to recognize that the Philippines is an archipelago. The implication is that the market needs to bridge the gap in space to provide real-time opportunities. Two credits cannot be priced differently if all that distinguishes them is location. Unless there is economic value to location, any such difference is simply arbitrage. Worse, the same credit cannot be priced differently as an investment opportunity in two different locations at the same time. That is simply blatant inefficiency, if not market bias.

Fortunately, technology has moved forward to allow us to fill gaps in time and space. Some time back, the BSP entered into a partnership with market stakeholders on the National Settlement Highway. The NSH is the technological backbone that will allow the public to efficiently clear and settle good funds across entities in different regions. More recently, the FI-BIOS was launched to provide retail investors in different regions with the capability to place investment orders on real time basis.

These are the type of technological innovations that help us address the unique situation of the Philippines. I trust that we can maximize the use of such facilities and make further innovations where needed.

Fourth and final initiative, the development of the bond market, whether GS alone or inclusive of corporate issues, will not be self-sustaining unless there is a financially-aware investing public. This is not a trivial task but the onus of providing the public with relevant information must be shared by all stakeholders, both regulator and the regulated. The recent passage of the PERA law together with its attendant IRR is a prime example of the type of financial awareness campaign that must be pursued. PERA itself is encompassing given the wide variety of products that may be offered. This can therefore be the linchpin for a concerted campaign and eventually extended beyond PERA.

Final thoughts

Ladies and gentlemen, I have covered quite a bit of ground here this afternoon. Some may choose to see this as an indication that there is much that is impaired with the Philippine bond market, particularly that of the government securities. I beg to differ since I have seen the strides that have been taken particularly in more recent times. Thus, I choose to see the vast potential this market can offer to the Philippines as a necessary vehicle to promote further economic development.

It would be a grave mistake however if we see the market simply as government securities. While it is true that in the Philippines the GS market in inherently linked to our fiscal situation, the broader development initiative cannot be held hostage by such limited concerns.

Fiscal consolidation is a continuing commitment and our collective efforts to address our fiscal position may soon come to fruition. Between now and the point of a sustainable national budget, the bond market needs to develop so that it moves beyond a largely fiscal-centric tool to one that can provide opportunities for both business initiatives and the investing public.

From the regulatory end, our commitment is to provide the enabling environment for the broad fixed income market to thrive. That will include the prudential framework that is needed for effective oversight and to protect the interests of the public. It will have to also include a stable macroeconomic environment where expectations on market prices and economic activity can be reasonably ascertained. This combination of a prudential framework and the ability to mitigate volatilities is certainly at the heart of a thriving fixed income market.

I will submit to you this afternoon, ladies and gentlemen, that indeed we have such an enabling macroeconomic environment before us. The outlook remains that of manageable inflation expectations, "within-target" inflation rates for 2009 and 2010, continuing remittances from overseas Filipinos, a surplus BOP position, market-driven peso value and interest rates that are responsive to our market's needs. Already the current low interest rate environment provides an interesting market backdrop for this point. Between a fixed coupon rate payable over the long-term and bank credit that is re-priced annually, the current environment appears to favour the former than the latter. Certainly, we have seen a number of debt issues structured of late and I am told that a few more are in the realm of the possible.

Ladies and gentlemen, I have no doubt that the GS market can very well serve as the catalyst for further reforms. The goal is to transform the market from a basic fiscal tool to a broader venue that migrates savers into investors while raising capital for productive initiatives. Instead of tapping foreign saving, entrepreneurs can very well raise funds locally without the complications of cross-currency cross-border risks. Instead of crowding out private saving, the GS market can act as the necessary base from which corporate credit can be properly priced and sourced. Instead of seeing its limitations, I see what the Philippines can do in this market and hold high hopes for its eventual success.

With that, ladies and gentlemen, I bid you all a pleasant afternoon.